

***United States Court of Appeals
for the Second Circuit***



AMICUS BRIEF

74-1537

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

RENEE SLADE,

Plaintiff-Appellee,

v.

SHEARSON, HAMMILL & CO., INC.,

Defendant and Third Party
Plaintiff-Appellant,

v.

NATIONAL BANK OF NORTH AMERICA,

Third Party Defendant.

On Appeal from the United States District
Court for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
AMICUS CURIAE

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
AMICUS CURIAE

STATEMENT OF THE ISSUE PRESENTED

After denying the motion of defendant Shearson, Hammill &
Co., Inc. ("Shearson") for partial summary judgment,^{1/} the court
below certified the following question for interlocutory appeal:

"Is an investment banker/securities broker who re-
ceives adverse material non-public information about
an investment banking client precluded from solicit-
ing customers for that client's securities on the
basis of public information which (because of its
possession of inside information) it knows to be
false or misleading?"

^{1/} [1973-74] CCH Fed. Sec. L. Rep. ¶ 94,329.

In so certifying, the district court stated that the question was one of first impression which had important implications for the structure of the securities industry.^{2/} Shearson petitioned this Court for leave to appeal the certified question and this Court granted Shearson's petition.

^{3/}
STATEMENT OF THE CASE

Defendant Shearson is a corporation engaged in the securities business as both an investment banker and a broker-dealer. As Shearson notes in its brief, it works closely with investment banking clients and necessarily, from time to time, learns inside information about them. Some of these clients have outstanding securities that are traded by public investors, including clients of Shearson's broker-dealer business.

Shearson states that it has internal policies and procedures pursuant to which Shearson's Corporate Finance Department, the department which carries on the firm's investment banking business, is prohibited from providing any inside information about an investment banking client to its Retail Sales Organization, the department which carries on its broker-dealer business. The Retail Sales Organization

^{2/} [1973-74] CCH Fed. Sec. L. Rep. ¶ 94,439 at p. 95,532.

^{3/} For purposes of the appeal of the certified question, the relevant facts do not appear to be in dispute. See Appellant's Brief, pp. 2-7; Appellee's Brief, pp. 2-6.

will recommend, as it deems appropriate, the purchase, sale or retention of a security; however, pursuant to Shearson's stated internal policies and procedures, the firm makes no recommendations with respect to the securities of an investment banking client. Shearson permits its salesmen, however, to make recommendations regarding the securities of an investment banking client, presumably based on the salesmen's own analyses of publicly available information.

Tidal Marine International Corporation ("Tidal") became an investment banking client of Shearson in October 1971. Although Shearson states in its brief that, pursuant to its policy prohibiting the recommendation of securities issued by investment banking clients, the firm never recommended Tidal securities, this would apparently not have prohibited a Shearson salesman from recommending such securities on the basis of publicly available information. In fact, Shearson states in its brief that, "[a]cting individually on the basis of extremely favorable public information," some of Shearson's salesmen "suggested the purchase of Tidal stock to various customers, including the two plaintiffs." Plaintiffs allege that at this time Shearson was in possession of material adverse information regarding Tidal, namely, that Tidal had suffered a disaster of major proportions, in the form of substantial damage to its fleet, and that due to the certain delay in processing insurance claims, Tidal would incur a shortage in cash required for continued operation. Plaintiffs allege in their complaints that these facts make out a cause of action under Section 10(b) of

the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder by the Commission, 17 CFR 240.10b-5.^{4/}

ARGUMENT

A BROKER-DEALER MAY NOT MAKE A RECOMMENDATION TO ITS CUSTOMERS ON THE BASIS OF INFORMATION WHICH IT KNOWS TO BE SUBSTANTIALLY INACCURATE, EVEN THOUGH ITS KNOWLEDGE RESULTS FROM MATERIAL INSIDE INFORMATION WHICH IT IS NOT ALLOWED TO USE IN EFFECTING SECURITIES TRANSACTIONS.

The Commission agrees with the court below that the certified question should be answered in the affirmative but is of the view that, contrary to the suggestion of the district court, the answer can and should be given without requiring far-reaching changes in the securities industry. The case involves two important principles: first, that persons who have been given material undisclosed information may not take advantage of it in the market; and second, that brokers must treat their customers fairly. The Commission believes these principles can be reconciled in this case and that such reconciliation may and should be accomplished in a manner that does not drastically or unnecessarily

^{4/} Although Shearson further claims in its brief to have received material adverse information about Tidal only "several weeks after the last of plaintiffs' purchases," this would appear to be an issue of fact which is not presented on this appeal, since the certified question assumes that at the time the transaction in question took place, the firm, due to its investment banking business, knew the material inside information. Similarly, plaintiffs' contention that Shearson did not effectively separate its investment banking and broker-dealer departments but allowed the former to pass only favorable information about Tidal to the latter is a question of fact not presented on this appeal.

impair the functioning of the securities industry or of our financial institutions and markets generally.

1. Misuse of Material Inside Information. The decisions with respect to "inside information," relied upon by the parties, do have an important bearing on the overall problem, but are not directly controlling in this case.

Shearson asserts that it was confronted with a situation factually similar to the position of Merrill Lynch, Pierce, Fenner & Smith, Inc., in that broker's litigation involving the stock of Douglas Aircraft Company.^{5/} It is true that Shearson, in its capacity as investment banker, had, like Merrill Lynch, received material nonpublic information of an adverse nature about an investment banking client, and, like Merrill Lynch, is charged with making recommendations to its brokerage customers. Despite these factual similarities the cases are, in the Commission's judgment, entirely different. Merrill Lynch was charged with using the adverse information as a basis for recommendations that its brokerage customers sell. The charge against Shearson is that, notwithstanding the adverse information, it recommended that its customers buy. In the Merrill Lynch situation this Court, following the teachings of its prior decision in Texas Gulf,^{6/} held, as the Commission had previously

^{5/} Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F. 2d 228 (C.A. 2, 1974); Merrill Lynch, Pierce, Fenner & Smith, Inc., [1967-69] CCH Fed. Sec. L. Rep. ¶ 77,629 (1968); Investors Management Co., Inc., [1970-71] CCH Fed. Sec. L. Rep. ¶ 78,163 (1971).

^{6/} Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833 (C.A. 2, 1968), certiorari denied sub nom. Kline v. Securities and Exchange Commission, 394 U.S. 976 (1969). In Texas Gulf, this Court recognized that insider-trading prohibitions are "based in policy on the justifiable expectation of the securities marketplace that all investors . . . have relatively equal access to material information." 401 F. 2d at 848.

held,^{7/} that Merrill Lynch violated Rule 10b-5 by using "material inside information" to the detriment of the market and of uninformed investors.

Plaintiffs refer to the language of this Court in its opinion in Texas Gulf to the effect that one may not recommend securities on the basis of material inside information. 401 F. 2d at 848. In thus using the word "recommending" in the context of the Texas Gulf case, however, this Court clearly was referring to the practice of "tipping," that is, suggesting that others buy securities on the basis of undisclosed favorable information, or sell on the basis of undisclosed adverse information. Shearson would, of course, have violated the Texas Gulf principle if, on the basis of the material adverse information obtained from Tidal, it had sold Tidal stock or had recommended that its customers do so. But the policy underlying the "inside information" cases, that material inside information not be taken advantage of in the market, does not appear to have been contravened in the present case since Shearson did not use that information. This Court's use of the word "recommending" cannot be extended to the situation of a brokerage firm making recommendations inconsistent with the inside information since no such situation was before the Court in Texas Gulf.

2. Fairness to a Broker's Customers. The foregoing does not mean that Shearson should prevail. Rule 10b-5 has consistently been held to prohibit recommendations by a broker which are contrary to

^{7/} Merrill Lynch, Pierce, Fenner & Smith, Inc., supra, n.5.

material information about the security known to, or reasonably ascertainable by, the broker. This Court in Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 592 (C.A. 2, 1969), held that the "optimistic representations or the recommendations [of securities salesmen] without disclosure of known or reasonably ascertainable adverse information which rendered them materially misleading" constituted such a violation. It held, in affirming an order of the Commission, that the standards applicable to a securities dealer are "strict," id. at 597, because such a person "occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders." Id. at 596 (footnotes omitted).^{8/} The Court summarized this standard of responsibility in the following words, id. at 597 (footnote omitted):

"He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation."

Accord, Securities and Exchange Commission v. Van Horn, 371 F. 2d 181 (C.A. 7, 1966). If a recommendation by a broker-dealer without an investigation that provides an "adequate and reasonable basis" for the recommendation is prohibited, a fortiori Rule 10b-5 prohibits a recommendation contrary to facts about the security in question known by

^{8/} See also Kahn v. Securities and Exchange Commission, 297 F. 2d 112 (C.A. 2, 1961); Charles Hughes & Co. v. Securities and Exchange Commission, 139 F. 2d 434, 437 (C.A. 2, 1943); Berko v. Securities and Exchange Commission, 316 F. 2d 137 (C.A. 2, 1963); R.A. Holman & Co., Inc. v. Securities and Exchange Commission, 366 F. 2d 446 (C.A. 2, 1966), modified per curiam on other grounds, 377 F. 2d 665 (C.A. 2), certiorari denied, 389 U.S. 991 (1967).

the broker-dealer.

3. Implications for Securities Markets and Financial Institutions.

Although the inside-information cases are not directly controlling here, they are, as noted earlier, relevant, since the undisclosed information known to Shearson that was contrary to Shearson's recommendations was material inside information which Shearson could not lawfully use or disclose. It is that fact which makes this case both significant and difficult, and which presumably gave rise to its being certified to this Court. The customers of a broker, who are normally entitled to the benefit of information the broker has, are not entitled to inside information that he possesses. As pointed out in the amicus brief of Salomon Brothers, extensive precautions are taken by responsible firms to isolate such information from those engaged in trading and brokerage activities, and the Commission in the Merrill Lynch proceeding looked with favor on efforts to take such precautions.^{9/}

No serious problems are created by requiring an individual corporate executive to refrain from trading in his company's securities or recommending such trading while he has material inside information.^{10/} But drastic consequences may flow from a rule which would preclude a brokerage firm from having any transactions with or on behalf of customers

^{9 /} Merrill Lynch, Pierce, Fenner & Smith, Inc., [1967-69] CCH Fed. Sec. L. Rep. at pp. 83,350-1. The Commission, of course, recognized that the value of the proposed arrangements would depend upon their effectiveness.

^{10/} It was to such persons that the admonitions against "recommending" in Texas Gulf were addressed. 401 F. 2d at 848.

in the securities of the perhaps numerous companies with which it has investment banking relationships, or from a comparable rule which would preclude a bank trust department from effecting transactions in securities of companies with which the bank has a commercial banking relationship.^{11/} There would normally be no need to impose such a Draconian requirement in these situations if persons in the firm who engage in securities transactions for customers are effectively isolated from any inside information which the firm may receive as an investment banker by the "Chinese Wall" referred to in the brief of Salomon Brothers. In that event, such transactions with securities customers would not

^{11/} These consequences are referred to in the brief of Salomon Brothers at pp. 9-10, 16 and 26. In short, the imposition of a rule designed completely to eliminate all potential conflicts of interest in the securities and banking industries would require, at least to a considerable extent, separation of functions. As the Commission has previously stated after consideration of this problem with respect to the securities industry:

"If all these functions were to be separated, the capital-raising capability of the industry and its ability to serve the public would be significantly weakened."

Securities and Exchange Commission, Statement of the Future Structure of the Securities Markets, [Special Studies] CCH Fed. Sec. L. Rep. ¶ 74,811 at p. 65,623 (February 2, 1972).

contravene the policy against the use of inside information.^{12/} With respect to the firm's duty to treat its customers fairly, any general obligation the firm might otherwise have to give customers the benefit of all available information cannot extend to "inside information." Indeed, affording them such a benefit would be illegal, and, as the Commission noted in Cady Roberts & Co., 40 S.E.C. 907, 916 (1961), a broker's obligations to his customers "could not justify any actions by him contrary to law."

Inside-information problems can arise in the context of various functions performed by brokerage firms. These differing contexts involve different considerations and may require different solutions. The critical factor in the instant case, the Commission believes, is that the recommendations of Shearson involved express, or, at least implied affirmative misrepresentations concerning the financial condition of Tidal. The preservation of necessary restrictions upon the

^{12/} Thus, in this case, Shearson appropriately instructed its Corporate Finance Department not to release information about its investment banking clients to its Retail Sales Organization until the information should be made publicly available by the issuer. It was the release of such information to a broker-dealer's trading department that led, according to the Commission's complaint in Securities and Exchange Commission v. Bausch & Lomb, Inc., 73 Civ. 2458, S.D. N.Y., 1973, referred to in appellant's brief (pp. 12-13), to the general partner of the broker-dealer in charge of the trading department selling a substantial number of shares of the stock affected by that information that were "in his account and in 13 family accounts, over which he had discretionary authority, prior to the public disclosure of such information and without disclosing such information to the purchasers." See paragraph 26, pp. 5-6, of the complaint. See also the discussion of the Bausch & Lomb complaint by the court below, [1973-74] CCH Fed. Sec. L. Rep. at pp. 95,131-32.

use of material inside information does not require that such misrepresentation be condoned.^{13/} They could be avoided with no drastic effects on a securities firm if it required its salesmen to observe the rule which Shearson has stated to be its policy, namely, that "the firm never recommends the securities of an investment banking client" (appellant's brief at 6). Through the use of a device such as a restricted list, as suggested in the Salomon Brothers brief (p. 5), outstanding recommendations could be withdrawn and further recommendations prevented. The use of such a list, by preventing salesmen from making recommendations with respect to securities as to which the firm may have material inside information, would avoid inadvertent violations by salesmen who are unaware of the inside information that may be inconsistent with information which served as the basis for the recommendation.

Of course, the firm's action in placing a security on a restricted list and in withdrawing an outstanding recommendation must be effected in a manner which avoids disclosure as to whether any material inside information possessed by the firm is in accord with or contrary to

^{13/} Salomon terms "unfortunate" the district court's use of the word "soliciting" in the certified question, arguing that the facts of this case present the situation where a transaction was not merely solicited but was affirmatively "recommended" by the defendant. (Salomon brief at 1.) It argues that the mere solicitation of transactions, in circumstances where no recommendation is advanced, should not be prohibited where, through the operation of an effective "Chinese Wall," the inside information known to the investment banking department is not known to the broker-dealer department. The Commission believes that if, however, the situation implies an affirmative representation, the solicitation should be prohibited. This would presumably not be the case in block-trading or marketmaking transactions not involving any express or implied opinion or representation as to the merits of the investment.

the recommendation.^{14/} Without suggesting that there are not other ways, we point out that one way to accomplish this is by the firm's adopting a general policy of placing a security on the list and withdrawing a recommendation at the time the firm enters into an underwriting or other financing involvement likely to result in the receipt of inside information--i.e., before such information has actually been received. If a firm adopts a general policy of withdrawing any outstanding recommendations when such a relationship arises and making no further recommendations (or permitting such recommendations by its salesmen) while the relationship continues, and if this policy is known to both its salesmen and its customers, it should then be possible for the firm to withdraw a recommendation without creating any inference that inside information has been received or as to the nature of any such information.

Of course, the best way of avoiding problems in this area is for the firm to take steps to bring about prompt public disclosure of the material inside information.

^{14/} Appellant's summary of the BARRON'S April 9, 1973 (page 5) interview with former Chairman Cook, contained in its brief at pages 23-24, appears to be inaccurate. There is no indication in the quoted interview that consideration was given to the question whether a recommendation might be withdrawn because the firm received inside information if it could do so without indicating whether that information was favorable or unfavorable.

CONCLUSION

While recognizing that we have suggested a pragmatic solution that may not be feasible for other types of situations that might arise, we submit that the foregoing views provide a proper balancing of the competing policies discussed above that will result in a just resolution of the question presented by this case. For the foregoing reasons, the Court should answer the question certified for review in the affirmative and affirm the decision of the court below.

Respectfully submitted,

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October 1974.



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WASHINGTON, D.C. 20549

October 23, 1974

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Re: Slade v. Shearson, Hammill & Co., Inc., No. 74-1537

Dear Mr. Fusaro:

We are delivering to you with this letter the original and three copies of a motion of the Securities and Exchange Commission for leave to file an amicus curiae brief. Four copies of the brief are also being delivered herewith. The remaining twenty-one copies of the brief are being mailed to you today.

I certify that a copy of the Commission's motion and two copies of the brief have been mailed on this date to each counsel of record. Counsel are also being advised that they may obtain copies of the brief tomorrow morning at the Commission's New York Regional Office.

Yours truly,

James H. Schropp
Attorney

Enclosures

